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International Economic & Energy Weekly

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18 May 1984

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Perspective

Economic Conditions and Political Instability in the Third World [redacted] 25X1

Economic conditions in Third World countries have deteriorated markedly in the past few years. Inflation, after averaging slightly under 20 percent annually in the early 1970s, soared to 35 percent a year in 1980-83. Third World GDP, in real terms, grew less than 1 percent in both 1982 and 1983; in Latin America it fell by almost 4 percent a year. During the same two years, imports by key debt troubled LDCs fell by 40 percent. These deteriorating economic conditions have raised fears of major political upheavals that might result in governments less favorable to US interests. [redacted] 25X1

At a recent conference of 80 academic, private-sector, and US Government economists and political-risk analysts, the issue of economic decline and instability was discussed. The general consensus was that the direct link between general economic conditions and political instability is at best tenuous. Although the conference participants addressed this relationship from their own areas of expertise, each concluded that the direct relationship was weak and uncertain. [redacted] 25X1

Several reasons were given for the lack of a clear coupling of broad economic trends and political instability, for example:

- According to an academic scholar who has just completed a study of the impact of IMF programs on stability, IMF conditionality may be a stabilizing force because it provides the domestic government with a foreign scapegoat for its economic woes. This can unify and direct the opposition toward an external source.

- The vice president of a major bank with extensive Third World loans felt that analysts too often underestimate the ability of the political and social fabric in developing nations to cope with severe economic strains. He cited, in particular, the continuing calm in Mexico despite several dire warnings last year about the dismal outlook for political stability.

- Another academician contended that economic growth in Third World countries can be more of a destabilizing influence than economic decline. He argued that growth can be destabilizing by breaking down traditional values and relationships—for example, in villages and among extended families. Conversely, economic difficulties can foster a return to more traditional norms and mitigate the hardships. [redacted] 25X1

Although the direct relationship between deteriorating economic conditions and instability appears to be weak, there was a general consensus that specific government actions to deal with economic decline can directly and adversely affect the population and spawn violent protest. There have been numerous examples over the past few months:

- Cuts in food subsidies led to wide-scale protests in Morocco and Tunisia earlier this year.
- Government-mandated price increases in late April resulted in food riots in the Dominican Republic.
- Cuts in public spending and dramatic increases in the price of government subsidized food caused a 72-hour strike in Bolivia earlier this month.

These acts of violence, however, do not necessarily lead to regime-threatening instability. Nonetheless, there remains the danger that when these events occur alongside other divisive political, social, ethnic, and external factors, they can lead to upheaval.

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Briefs

Energy

More Attacks on Tankers in the Persian Gulf

Iraqi and Iranian attacks on shipping during the last week suggest the level of military activity in the Gulf probably will increase sharply. Iranian aircraft on Sunday attacked and slightly damaged a Kuwaiti tanker. On Monday, aircraft evidently from Iran attacked and heavily damaged at least one more Kuwaiti tanker. On Wednesday, US AWACS aircraft detected Iranian F-4 fighter aircraft in the area where a Saudi tanker was attacked. Iraqi Super Etendard aircraft were detected by AWACS south of Khark Island late on Sunday; press reports indicate that a 69,000-ton Iranian tanker was hit in this attack. A 62,000-ton Greek tanker was also on fire following an Iraqi attack on Sunday near the Saudi tanker attacked on 7 May. Both had been at Khark. 25X1 25X1

Iran may feel it will have to respond to each Iraqi attack to lend credibility to its recent warnings. If the retaliation fails to deter Iraqi attacks, the Iranians may decide to expand their raids to shipping bound for Saudi Arabia and the Arab states in the southern part of the Gulf. For its part, Iraq probably hopes that increased hostilities in the area will spur the Gulf states into providing more support for Iraq. Baghdad also hopes the attacks will increase international pressure on Iran to negotiate an end to the war. 25X1

President Saddam Husayn has publicly claimed that US AWACS aircraft are providing the Iraqis with information on Iranian activities, according to a British press report. Iran has issued a statement accusing the United States of being behind the Iraqi attacks and reiterating its warning that it would make the Gulf unsafe for shipping if Tehran is unable to export oil. Saddam's statement increases the danger that Iran will attack US ships and aircraft in the region, even though the AWACS usually fly well inside Saudi territory. The Iranians also could instigate terrorist attacks against US personnel in Saudi Arabia. Saddam's claim to have received information from AWACS is unconfirmed, 25X6 25X6

Reaction to Tanker Attacks

Kuwait and Saudi Arabia are unlikely to react strongly to the recent Iranian attacks on tankers unless the attacks continue. The chairman of the Kuwait Oil Tanker Company early this week told US Embassy officials that Kuwait would continue to ship oil. The chairman speculated that the Saudis and Kuwaitis might consider either a convoy system or military escort for merchant vessels. Kuwait and Saudi Arabia probably could not provide effective air cover for shipping or adequate naval escorts. Neither country's air force has trained extensively in protecting naval vessels and merchant shipping. The Saudi Navy lacks adequate air defense weapons, and Kuwait has only coastal patrol vessels. 25X1 25X1

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Because the Arab nations on the Persian Gulf are conscious of their military weakness and fear provoking additional attacks, they are reluctant to condemn either Iran or Iraq directly. Saudi Arabia and Kuwait are likely to urge Baghdad privately to stop the attacks on shipping that invite Iranian retaliation, but Iraq will continue to conduct periodic airstrikes. [redacted] 25X1

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[redacted]

25X1 *French Energy Self-Sufficiency*

[redacted]

France produced 39 percent of its total primary energy consumption last year. Its energy self-sufficiency is 16 percentage points higher than 10 years ago. France is the only major West European country to significantly improve its energy self-sufficiency without developing large new oil and gas fields. A rapidly expanding nuclear power program combined with an aggressive electrification campaign is largely responsible for the reduced French dependence on imports. Although dependence on coal and natural gas imports increased as a result of efforts to diversify energy sources, net petroleum imports dropped by one-third. During this period, total primary energy consumption grew by slightly less that 2 percent because of high energy prices, reduced economic growth, and improved efficiency. [redacted] 25X1

Indonesia Seeking New LNG Markets

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[redacted]

Jakarta is currently negotiating sales of LNG to Taiwan and, [redacted] expects to sign a three-year contract with Kuwait. Huffco, the US firm operating the Badak gasfield in East Kalimantan, has held preliminary talks with Taiwan officials and expects that deliveries could begin in three years if agreement is reached. The Kuwaiti market has emerged because cutbacks in Kuwait's crude oil production have resulted in shortfalls in domestic gas supplies. Deliveries could begin within several months. Jakarta has sufficient surplus capacity only to supply either the Taiwan or the Kuwaiti market, and only if Japanese buyers do not exercise their option to make additional purchases of up to 1 million tons annually. If Jakarta signs new long-term contracts and the Japanese exercise their options, the Indonesians would have to add another LNG production unit by 1986. [redacted] 25X1

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Renewed Western Interest in Vietnamese Offshore Petroleum Concessions

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Western energy companies are showing interest in offshore concessions in an area of the South China Sea where a US firm made a small oil find in 1974. Since the last three Western firms abandoned Vietnamese waters in 1980, Hanoi has given exclusive exploration rights to Viet-Sov-Petro, a joint Vietnamese-Soviet enterprise. [redacted] 25X1

[redacted] 25X1

International Finance

South American Reaction to Higher US Interest Rates

25X1 [redacted]

The recent increase in the prime interest rate is drawing fire from South American leaders and will strain financial rescue programs. Argentine President Alfonsin's public denunciation of the development prompted government leaders in Mexico, Brazil, Venezuela, and Colombia to issue a joint statement decrying the increase. Argentine congressmen—already unhappy with rising inflation—are claiming that the higher rate will prevent economic recovery and threaten social peace. The US Embassy in Brasilia reports that the government has reacted with uncharacteristic harshness and believes the higher rates could nullify gains made in its financial adjustment program. [redacted] 25X1

[redacted] 25X1

Despite predictions of a resurgence of financial problems, the immediate impact on Latin American debtors will be minimal. Interest rates are adjusted every three to six months, and the new increase will not take effect until later this year. Nonetheless, once it does take effect, an increase of 1 percentage point in short-term interest rates adds about $2 billion to Latin America's annual net interest payments. [redacted] 25X1

The higher interest rates could provide a rallying point for Third World debtors. Latin American governments probably will issue a collective statement against the interest rate and trade policies of industrial countries before the London Economic Summit. They may also intensify demands for repayment concessions from private bankers to offset the impact of higher rates in future debt negotiations. [redacted] 25X1

Argentina's Slow Progress Toward IMF Agreement

Buenos Aires appears to be making little progress toward agreeing on the terms of a letter of intent with the IMF team currently in the country. Although Central Bank President Garcia Vazquez last week confirmed to the US Embassy Argentina's intention to complete fund negotiations by the end of May, we believe the deadline is unrealistic. The Embassy reports that a lack of a credible budget is hampering progress in talks with the Fund. Presidential adviser Raul Prebisch told Alfonsin last week that some government agencies have not provided monetary and budget data needed for the Fund discussions. In an effort to overcome bureaucratic foot-dragging, Alfonsin directed Prebisch to tell each department exactly what information is needed and to demand it on presidential orders. Prebisch is then to travel to the United States where he will explain the efforts to resolve data problems and try to convince creditors that Argentina is not stalling. If an IMF letter of intent is delayed until June— which we now believe to be highly probable—it is likely to prevent Buenos Aires from meeting its self-imposed, midyear deadline for completing its 1984 refinancing plan. [redacted] 25X1 25X1

Brazil's Improving Foreign Exchange Position

A $3.5 billion trade surplus for the first four months of 1984 has decidedly improved Brazil's foreign exchange position. The US Embassy reports that, with the major agricultural export months still ahead, Brazil is within easy reach of the trade surplus target of $9 billion pledged to the IMF. According to the Embassy, the apparent success in meeting IMF performance criteria during the first quarter of the year should assure continued support from foreign creditors. Bankers now believe, [redacted] the country will have a manageable cash flow without the need to borrow additional funds until 1985. Brasilia is likely to use a strengthened payments position to begin restoring growth to the economy, perhaps by midyear as the presidential elections draw near. [redacted] 25X1 25X1 25X1

Colombian Financial Update

We concur with a recent US Embassy report that the financial difficulties experienced by Colombian banks represent the first stages of a foreign exchange crisis. Banco de Colombia, the country's largest bank, has requested refinancing of $670 million in short-term debt. Banco de Bogota, the next largest bank, has suspended foreign debt servicing. As a result, foreign credit lines are being cut. Moreover, [redacted] capital flight is accelerating. With Colombia's liquid reserves being depleted and exports still lagging, Bogota probably will have to turn to the IMF soon to obtain a loan and to establish an adjustment program before attempting to reschedule its debts. [redacted] 25X1 25X1 25X1

Moroccan Debt Rescheduling Delays

Morocco's commercial bank creditors are growing concerned about delays in completing a debt rescheduling agreement with the government covering about $500 million in 1984 obligations. The government's refusal to list the Central Bank as a guarantor of the restructured debt remains the primary obstacle to reaching an accord. The foreign commercial bank's position—known as the 25X1

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Mexican solution—calls for the Moroccan Central Bank to guarantee repayment up to the extent of its foreign exchange holdings. The Finance Ministry accepts this compromise, [redacted] but has not yet 25X1 convinced the Central Bank to make this concession. Although most of Rabat's 200 commercial creditors so far have honored a "gentleman's agreement" to maintain short-term credit lines until a rescheduling accord is signed, we believe this agreement will begin to unravel if progress on rescheduling is not forthcoming soon. [redacted] 25X1

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Continued Iraqi Gold Sales

[redacted]

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Iraq continued to sell gold reserves in March and April. [redacted] 25X1 [redacted] sales during the two months amounted to $130 million. Total gold holdings are now about $1.4 billion, 30 percent less than in October when the selloff began. We estimate total Iraqi official reserves, including gold, have fallen from $31 billion at yearend 1980 to slightly below $3 billion. We expect Iraq to request a rescheduling of its estimated $4 billion in commercial bank debt later this year. [redacted] 25X1

Kuwaiti Foreign Investment

[redacted]

The Kuwait Public Investment Authority (KPIA) is scheduled to begin operation on 1 July, according to the US Embassy. The KPIA will oversee and set overall investment policy for about 90 percent of Kuwait's $67 billion in foreign assets. Shaykh Ali Khalifa Al Sabah, Minister of Oil and Finance, will head the organization, and the governing board will comprise both public and 25X1 private members. We do not expect any major near-term change in Kuwaiti investment policy. We believe, however, the KPIA will have a difficult time gaining control over the various government investment accounts which currently are managed by the Ministry of Finance, the Central Bank, the Kuwait Fund for Arab Economic Development, a couple of investment companies, and a few nonfinancial public enterprises. The Kuwait Investment Office in London, which autonomously manages a $10 billion investment portfolio, may be particularly reluctant to accede to KPIA's oversight. Some $4 billion in foreign assets of the Kuwait Petroleum Company—already directly under Ali Khalifa—are specifically excluded from KPIA oversight.
[redacted] 25X1

Moscow Raises Western Loan

[redacted]

The Soviet Foreign Trade Bank, Moscow, and Dresdner Bank International, Luxembourg, have reached agreement on a $250 million general purpose loan syndication, after a six-month search for participants. US banks are not taking part in this syndication. Although the loan originally received a cool reception in the Euromarket, the final subscription is more than the original request. The Soviets agreed to pay an upfront management fee and shorten the term of the 25X1 loan from its original request to attract lenders. Enough Western banks indicated interest—31 participated—that the share of risk borne by any one bank was reduced to acceptable levels, [redacted] 25X1 25X1

Summit Issues

Ottawa Criticizes US Interest Rate Policy

Canadian Finance Minister Marc Lalonde has strongly condemned the latest hike in the US prime interest rate and is calling on other industrial nations to unite in urging Washington to force rates down. He will seek international support for his position at the OECD ministerial this week and is recommending that Trudeau do likewise at the London Summit in June. Lalonde, responding to opposition parties' criticism of high domestic interest rates, claimed that Canadian banks have no choice but to follow US rate hikes, despite the widespread fear that rising rates will abort Canada's recovery.

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To soften the negative impact of higher interest rates on investment, Ottawa is keeping Canadian rates slightly below those of the United States; usually they are higher. As a result, capital is moving to the United States, causing strong downward pressure on the Canadian dollar. Although the Bank of Canada has intervened—it used an estimated $1.1 billion in March and April—the Canadian dollar dropped in value from approximately US 81 cents at the end of 1983 to nearly US 77 cents in May. Canadian analysts estimate that the decline in the dollar's value, by increasing the costs of imports, will add more than 1 percentage point to Canada's inflation rate. Ottawa has little control over Canadian interest rates, and its frustration with US policy will mount if US interest rates rise further, the Canadian dollar falls, and recovery slows.

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London Blames United States for Increase in British Interest Rates

Prime Minister Thatcher is coming under increasing pressure to join in criticism of the US budget deficit and high US interest rates at the London Summit because of the rise in British interest rates last week and the expectation in London's financial markets that rates will go higher to forestall widening the US-UK interest rate differential. Major British banks raised their base lending rates 0.5 to 0.75 percentage points to 9.0 to 9.25 percent. The Bank of England followed the trend with a 0.5-percentage-point hike in its discount rate. Until now, prime loan rates have been cut successively since peaking at 11 percent in January 1983. In addition, sterling touched its record low against the dollar last week, but remained stable against all foreign currencies on a trade-weighted basis. Chancellor of the Exchequer Nigel Lawson blamed the turnaround in British rates on "market pressures" from the United States. Lawson characterized the change as an "unwelcome interruption to the downward trend of recent years," but emphasized that the increases did not place the United Kingdom's economic recovery in immediate jeopardy.

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Reduced Government Spending in France Strains Coalition

Government spending in France probably will be tighter in 1985 than in 1984. According to US Embassy and press reporting, the basic outlines for next year's budget are the first concrete steps confirming the Socialists' intention to maintain austerity through 1985. Public employment will fall 1 percent,

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largely through attrition, and operating expenses will be reduced 2 percent. The proposed reductions in spending reflect two Mitterrand pledges: to reduce the share of GDP going to taxes and social charges by 1 percentage point and to maintain the fiscal deficit at 3 percent of GDP. [redacted] 25X1

The proposed budget promises to generate harsh debate. The Communists have accused the government of ratcheting austerity another notch and of violating Socialist-Communist agreements. This will further fuel strains within the left coalition that recently have increased because of government efforts to modernize French industry. [redacted] 25X1

Global and Regional Developments

Tokyo Plans To Resume Export Insurance for Cuba

25X1 [redacted]

The Japanese Ministry of International Trade and Industry (MITI) has resumed export insurance for trade with seven LDCs, including Cuba, according to the press. MITI previously refused to underwrite insurance for nations undergoing debt rescheduling, but now believes trade prospects with Cuba and the other countries warrant coverage. Although firms will be covered only partially and premiums will be high, Tokyo's action will be welcomed by Havana. Japanese trade with Cuba dropped precipitously after export insurance was suspended in 1982. [redacted] 25X1

Japanese Aid for Soviet Phosphate Project

25X1 [redacted]

[redacted] the USSR plans to develop East Siberian 25X1 phosphate deposits with Japanese assistance. This is the first known instance of a Western country's participation in phosphate mining in the USSR. Moscow plans to invest $190 million over the next 10 years to develop the Seligdar phosphate deposits near Aldan in East Siberia. Seligdar's phosphate reserves are estimated at 3 billion metric tons. Development of the deposit will make it possible to increase supplies of badly needed phosphate fertilizer to Siberia—supplies currently are transported from the western part of the country. [redacted] 25X1

Canada Signs New Fisheries Treaty with USSR

25X1 [redacted]

Ottawa and Moscow, after three years of negotiation, signed a new fishing treaty on 1 May allowing increased Soviet catches in Canadian territorial waters. The agreement—which can be terminated by either signatory with 12 months' notice—permits Soviet fishermen to take 100,000 metric tons of fish in 1984, an increase of 25 percent over 1983. In return, the Soviets have agreed to purchase $12 million in processed Canadian fish products in 1984. According to press reports, the USSR has resisted earlier attempts by Ottawa to promote purchases. Although the total is a small portion of Canada's total annual fish exports of $1.6 billion, Canadian Fisheries Minister DeBane said that he hopes to expand sales to the USSR in the future. In addition, DeBane said that he expects the Soviet fishing fleet to begin using drydock facilities in St. John's, Newfoundland, for repairs. [redacted] 25X1

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Bulgaria Providing Assistance to Nicaragua

[redacted]

Bulgarian deliveries of economic and military aid to Nicaragua suggests that Moscow has chosen Sofia to assume an important role in supporting the Sandinistas. Economic relations have expanded since Sofia and Managua opened diplomatic relations in 1979. Bulgaria has donated 20,000 metric tons of wheat to Nicaragua and granted $110 million in credits to buy commodities and to finance development projects. Bulgaria has also become the leading source of Soviet and East European arms in meeting the Sandinistas' needs. Most of the equipment and weaponry probably is from Bulgarian inventories that have become surplus as Sofia modernizes its military. [redacted] 25X1 25X1 25X1

Argentina and Mexico Sign Five-Year Grain Agreement 25X1

[redacted]

Mexico will buy a minimum of 1 million metric tons of grain annually for five years under the recently signed Long-Term Grain Agreement with Argentina, according to a US Department of Agriculture report. So far in 1984, Mexico has purchased roughly two-thirds of this minimum amount. Financing will be handled through a bilateral clearing account with Argentina probably buying oil and fertilizer from Mexico. Buenos Aires's interest in the deal is consistent with its official policy of redirecting grain exports toward its Latin American neighbors. Since the United States lifted its partial embargo on grain shipments to the Soviet Union in 1981, Argentine sales to Moscow have fallen. In the current market year ending 30 June, Argentina's Soviet grain sales will comprise about 30 percent of its total grain exports, compared with 50 percent the previous year. [redacted] 25X1 25X1

Nonetheless, the United States will remain Mexico's principal grain supplier. [redacted] 25X1

Indian Dysentery Epidemic

[redacted]

The epidemic of shigella dysentery in West Bengal could sweep throughout India and into neighboring countries. The Indian Minister of Health and other sources say this virulent dysentery has infected more than 38,000 people in West Bengal since late March. There have been about 1,400 recorded deaths since then—mostly young children. The size and seriousness of the epidemic could increase rapidly because the hot and wet summer months will be favorable for transmitting dysentery. Checking the spread of the disease will be very difficult because of poor sanitation, crowding, contaminated water, and hordes of flies. The causative organism is a strain of shigella dysenteriae that has become resistant to all readily available antibiotic drugs. Vaccine under development in the United States requires one to two years' more research and testing before it is acceptable for widespread use. [redacted] 25X1 25X1

Cocoa Talks Falter

After making little progress this week in Geneva on a new International Cocoa Agreement (ICCA), cocoa producers and consumers are planning to meet again before the present pact expires in September. Among the issues still to be settled are:

- The use of export quotas to complement the buffer-stock mechanism of the current agreement. The stringent preconditions in the current ICCA for implementing export quotas effectively bar their use. 25X1

- The minimum support price. [redacted] it is possible that a minimum price will be negotiated under a separate agreement after a new ICCA is ratified. This would allow countries such as the Ivory Coast—the world's largest cocoa exporter—to join the International Cocoa Organization, despite disagreement over the minimum price level. [redacted] 25X1 25X1

Although cocoa prices have recently reached the ICCA minimum target price of $1.10 a pound—buoyed by crop shortfalls because of drought, fires, mismanagement, and political instability in West Africa—prices remain a third lower than prerecessionary levels. Even with a new agreement, we believe cocoa prices are unlikely to rise significantly over the long run because of increasing production in Brazil and Malaysia and the growing use of substitutes. Ghana and the Ivory Coast are hurt the most by soft cocoa prices. [redacted] 25X1

National Developments

Less Developed Countries

Potential for Jamaican Unrest

The opposition People's National Party reportedly is planning a massive protest demonstration next Tuesday, when Prime Minister Seaga presents his new austerity budget to Parliament. The US Embassy reports that the government has agreed to nearly all the steps required for approval of an IMF loan program. The austerity measures probably will include increases in the prices of electricity and telephone service, the removal of subsidies on some petroleum products, and the gradual elimination of food subsidies. The new austerity measures, combined with the devaluation of the Jamaican dollar and shortages of foreign exchange and credit, will raise the cost of living, slow production, and bring unemployment close to 30 percent this year. This may provoke unrest. [redacted] senior officials of the ruling Jamaica Labor Party are concerned about the ability of the security forces, especially the police, to prevent violence. [redacted] 25X1 25X1 25X1

Libyan Agricultural Problems

Libyan agricultural projects have not been allocated budgeted funds for the first quarter, and several large projects are behind schedule, according to a generally reliable source. The source says that agricultural funding has been cut by 20 percent to support the Great Manmade River Project—a showcase program of the Qadhafi regime. Delayed spare parts purchases have reduced grain planting to half of the available area at the important Sabha and Sarir agricultural projects. In addition, an increasing number of skilled workers at the large development projects are reported to be leaving because Tripoli is forcing them to accept half their salaries in Libyan dinars—a nonconvertible currency. With food imports slashed 40 percent from their 1981 peak, lower domestic grain production probably will add to domestic discontent.

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Nigeria's New Austerity Budget

The government last week announced a new austerity budget amid growing criticism of its policies. The budget provides for increased debt servicing and measures designed to reduce domestic demand such as freezing wages, curtailing credit expansion, and raising tariffs. Official revenue projections are based on oil production matching Nigeria's OPEC quota of 1.3 million barrels per day. Head of State Buhari, in announcing the budget, held out hope of reaching a compromise with the IMF on an economic adjustment program. He made no mention, however, of Nigeria's unwillingness to devalue its currency or to eliminate petroleum subsidies to consumers.

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The new budget, if followed, would go a long way toward meeting IMF recommendations. The military regime, on the other hand, is likely to back off at the first sign of popular opposition to its economic policies. With no economic solace to offer and with the start of controversial corruption trials looming, the government can do little to revive its image. Buhari may feel compelled to clamp down even more if the public sniping persists.

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Liberian Rubber Industry Improves

Firestone, Liberia's largest foreign rubber concessionaire, is projecting profits from its Liberian operations for the first time in several years, and the firm will resume tax payments. The resurgence in world rubber prices, which in February reached 58 cents per pound—50 percent higher than the low in late 1982—have encouraged the company to continue its Liberian operations. Early rains this year that probably will raise rubber production and cost-cutting measures are helping as well.

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Firestone's commitment to remain in Liberia will benefit the Doe regime. Natural rubber is Monrovia's second most important export commodity behind iron ore. In addition, Liberia benefits from expensive social welfare projects—schools, housing, medical facilities, and transportation—that Firestone provides for its 20,000 workers—40 percent of the country's salaried work force.

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Dismantling of Philippine Sugar Monopoly

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The seesaw struggle for control of the vital Philippine sugar-marketing industry is beginning to tip in the producer's favor, according to US Embassy reporting. Early this month, President Marcos accepted the producers' proposal for postponing free export trading until August to permit the development of alternative marketing channels. Producers had been under pressure by sugar trading czar Roberto Benedicto—an associate of Marcos—to sign long-term sales contracts with his National Sugar Trading Corporation. The politically vocal sugar producers, however, convinced Marcos to ease the corporation's control over marketing, a reform the World Bank strongly supports. According to the US Embassy, Marcos now perceives Benedicto as a political liability whose empire should no longer enjoy special protection. 25X1

Communist

Yugoslavian Price Policies Cause Feed Shortages and Livestock Slaughtering

Government price controls on feed and livestock products have caused feed shortages and widespread slaughtering of livestock in Yugoslavia. With the official price of corn fixed some 30 percent below the free market price, private corn farmers—who account for 80 percent of production—have refused to sell much of their crop to the socialized sector. They anticipate higher prices later. With prices of many livestocks products set below producers' costs, farmers in both the socialized and private sectors have chosen to step up slaughtering. This will continue the decline in livestock herds that took place in 1983. Moreover, despite the increased slaughtering, we believe the government will fall short of its goal of boosting hard currency earnings through increased meat production and exports. 25X1

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USSR Cuts Fish Prices

Moscow cut state retail prices for some canned and preserved fish products by 37 to 40 percent on 20 April, according to Soviet press reports. Sales of fish and fish products represent about 3 percent of state and cooperative food sales. The price cuts probably are intended to reduce excess inventories. Preliminary Soviet data indicate that processing of fish and fish products grew by 5 percent last year, while retail sales declined 2 percent. Overall prices in state and cooperative stores may have declined slightly since the start of 1984 following increases in 1982 and 1983. Official data for the first quarter show that retail sales rose by about one-half a percentage point more in real than in nominal terms. 25X1

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Vietnamese Plans for Rice Stockpile

Hanoi last month told the French company that handles Vietnamese rice exports to Western countries that it intends to reduce planned 1984 rice exports from 120,000 to 60,000 metric tons. Industry experts believe that the rice will not be diverted to Communist countries as in previous years, but will be used instead to build a grain stockpile. Although Vietnam last year reached self-sufficiency in grain for the first time since reunification in 1975, it has had no food reserve to protect against bad crop years. Smaller rice exports will cost Hanoi badly needed foreign exchange. 25X1

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Summit Issues: Big Six Economic Outlook

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The long-awaited economic recovery is finally under way in all of the Big Six countries, although nowhere is it as robust as in the United States. Real GNP growth this year is likely to reach 4 to 5 percent in Japan and Canada, 3 percent in West Germany and the United Kingdom, and 1.5 to 2.0 percent in France and Italy. More important, the pickup so far has occurred without rekindling inflation, which is down to less than 6 percent in all of the countries except France and Italy. All of the Six should achieve at least near balance in their current accounts in 1984, while Japan is likely to top the record $21 billion surplus recorded last year. None of the Six, however, has yet made much progress in reducing joblessness.

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Japan

With strong foreign demand and increased investment leading the way, we expect real GNP growth this year to approach 5 percent—the best mark since 1979. Despite the upturn, inflation remains well under control—price increases should be in the 2-percent range in 1984. The recovery so far has had only a slight impact on the labor market. Although the ratio of job offers to applicants is up in recent months, unemployment is still running officially at 2.7 percent—relatively high by past Japanese standards. Government fiscal policy remains tight in an effort to cut the persistent budget deficit. This year's central government budget calls for spending to decline by 2 percent in real terms.

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Japan is headed for a record current account surplus, fueled by the yen's weakness against the dollar and by economic recovery in the other industrialized countries, particularly the United States. We expect the 1984 surplus to top the $21 billion figure recorded last year. Although Tokyo is implementing a package of highly visible measures to increase imports and reduce trade frictions, these measures will have little effect this year.

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West Germany

The accelerating recovery is leading many forecasters to boost their forecasts of 1984 GNP growth into the 3- to 3.5-percent range, up from 1.3-percent growth last year. Unemployment remains the most pressing problem, although it is down somewhat from the 9.4-percent peak last August. The labor force is growing by about 200,000 persons annually, but employers are reluctant to hire because of the difficulty of dismissing an employee. Inflation, however, is only 3 percent and shows no signs of picking up. The current account surplus, which reached $4 billion in 1983, should rise substantially this year, partly because of the past depreciation of the deutsche mark against the dollar.

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The governing coalition faces an internal disagreement over a pledged income and wage tax cut. Finance Minister Stoltenberg wants the cut to take effect in 1988, and he wants half of it offset by hikes in other taxes. The Free Democrats—fearing for their existence as a party—would like the tax reduction earlier and with minimum offsetting increases in other taxes. In addition, Bonn faces a labor dispute that could disrupt the recovery, as the Metalworkers Union plans to strike key factories over its demand for a 35-hour workweek with no cut in pay.

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Big Seven Economic Indicators [a]

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	Real Economic Growth (*percent*)			Consumer Price Inflation [b] (*percent*)			Unemployment Rate [b] (*percent*)			Current Account Balance (*billion US $*)		
	1982	1983	1984	1982	1983	1984	1982	1983	1984	1982	1983	1984
Japan	3.3	3.1	4.9	2.6	1.8	2.5	2.4	2.7	2.6	6.9	21.0	27.0
West Germany	−1.1	1.3	3.0	5.3	3.0	3.0	7.7	9.2	9.0	3.4	4.0	7.0
United Kingdom	2.1	3.5	2.8	8.6	4.6	5.5	11.7	12.4	12.5	9.2	3.1	1.1
France	2.0	1.0	1.5	12.0	9.5	7.2	8.4	8.5	9.5	−12.1	−3.8	0
Italy	−0.3	−1.2	2.0	16.4	14.9	12.0	9.1	9.9	10.4	−5.8	0.5	0.5
Canada	−4.4	3.0	4.3	10.8	5.8	5.6	11.1	11.9	10.8	2.4	1.3	0.2
United States	−1.9	3.4	5.7	6.2	3.2	4.5	9.6	9.4	7.5	−11.2	−40.8	−86.2

[a] OECD forecast for United States; CIA forecasts for the other countries.
[b] Annual average.

United Kingdom

The United Kingdom led the economic recovery in Western Europe last year, and real growth near the 3-percent level is likely again in 1984. The outlook for investment is particularly promising, as rebounding profits have buoyed business confidence. In addition, many corporations may accelerate capital spending to take advantage of generous depreciation allowances before they are reduced by recently legislated tax changes. Britain's trade picture should be somewhat brighter this year, as exports benefit from the worldwide recovery.

The Thatcher government's major policy concerns continue to be the 12-percent unemployment rate and inflation—which probably reached its cyclical low at 4.6 percent last year. The government's belief that it is vulnerable on the unemployment issue has been accentuated by recent Tory losses in elections for local councils and vacated parliamentary seats. London, however, is relying on continued economic growth rather than on specific measures to reduce joblessness, and progress is likely to be slow. Although union power has been diminished by recent legislation and by high unemployment, Thatcher is concerned that the current good economic news may spur demands by labor for higher wage settlements, which could undermine her strategy for holding down inflation.

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France

French GDP growth slightly exceeded 1 percent in 1983 with the increase stemming largely from growing export demand. We expect continuation of the March 1983 austerity program to constrain growth to 1.5 percent this year. Price pressures abated somewhat last year, but inflation still held stubbornly close to 10 percent. Recent moderate wage increases in the private sector—which for the most part have been within government guidelines—point to slower inflation this year. The current account improved dramatically in 1983, the deficit falling from $12 billion to below $4 billion, and we expect it to be in balance in 1984. Unemployment, on the other hand, increased slightly last year and is expected to average above 9 percent in 1984.

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Italy

Italy was the only major OECD country to experience a decline in real GNP in 1983, as a moderate export-led economic recovery began only late in the year. This year real growth could reach 2 percent, with private consumption stimulated by an increase in real wages and transfer payments. In addition, stronger demand and declining interest rates should encourage investment. The inflation picture will also improve somewhat, as lower wage gains hold price increases to about 12 to 13 percent this year—still the highest rate among the Summit countries.

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Despite the pickup in growth and government plans to hire an additional 20,000 public employees, the unemployment rate is likely to exceed 10 percent this year. We believe the trade deficit will worsen from last year's $3 billion, mainly because of higher imports. Rome expects the increased trade deficit to be offset by improved invisibles earnings, thus preserving the small current account surplus recorded in 1983.

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Prime Minister Craxi's Socialist-led government is trying to address Italy's economic problems by reducing the enormous budget deficit and placing limits on the extensive wage indexation system. Although the coalition parties worked out a compromise on the budget issue, the Communists are still opposing changes in wage indexation in an effort to shore up their support and show that Italy cannot be governed without their acquiescence. As a result, the indexation proposal has been weakened—and still awaits parliamentary approval—while the 1984 budget deficit will probably exceed the staggering 16.6 percent of GDP recorded last year. In order to avoid excessive monetary expansion, the Bank of Italy consequently will have to continue to maintain relatively high real interest rates on government debt.

Canada

Economic recovery is progressing more rapidly in Canada than in most Summit countries. Real GNP growth probably will surpass 4 percent in 1984 as the recovery broadens. The slowing inflation rate—4.7 percent during the last 12 months—is encouraging continued consumer spending. US demand for Canadian exports also is contributing to the growth of the economy. Nonetheless, we expect Canada's trade surplus to narrow slightly because of increased import demand, and a rising services deficit is likely to put the current account in approximate balance this year.

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Private investment remains weak because businessmen apparently doubt that the recovery can be sustained. We believe they are afraid that the stronger US recovery and Washington's greater success at reducing inflation will drive the Canadian dollar down and interest rates up, which could abort the slow recovery in investment. Also clouding the outlook is the recent rebound in the unemployment rate—to more than 11 percent. The Liberal government is unlikely to adopt expansionary policies to create jobs, however, because of an already large budget deficit and fears of refueling inflation. Trudeau's retirement, the process of selecting his replacement, and the likelihood of an election this fall will hamper Ottawa's ability to direct economic policy this year.

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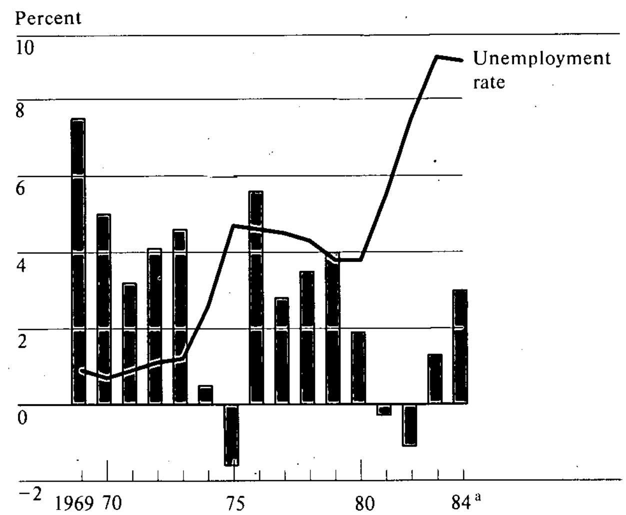
West Germany: Accelerating Recovery

The West German economy is in the second year of a recovery that has far outpaced earlier expectations. Kicked off early last year by consumer spending, sustained by strong investment, and finally buoyed by an export boom, the accelerating recovery is leading many forecasters to boost their 1984 GNP growth projections into the 3.0 to 3.5 percent range. West Germany's 1984 current account surplus should be substantially larger than the $4 billion figure recorded last year. Despite stubborn high unemployment, the government presently plans to continue its austere fiscal policy at least through 1985.

West Germany: Real GNP Growth and Unemployment, 1969-84



[a] Forecast.

Origins of the Upturn

A surge in private consumption early in 1983 began the economic upturn, making this the first postwar West German recovery not led by exports. Although real disposable income was down somewhat in 1983, consumers turned to savings and credit to fund auto and other consumer durables purchases that had been postponed during the recession. When the consumption boom faded last summer, following a 1-percentage-point increase in the value-added tax (VAT), accelerating private equipment investment took up the slack. Last fall export orders started to pick up. With exports representing one-third of GNP—the highest share in the Big Seven—business optimism spread quickly with the first signs of recovery in foreign demand.

After a broad-based 1.3-percent increase in real GNP last year, the economic upswing is now accelerating. Industrial production and new orders are up sharply—reaching prerecession levels—while profits and business confidence show remarkable improvement. Most importantly, foreign orders in first quarter 1984 were 13 percent ahead of the year-earlier figure. In addition, the Hanover Fair in April—the world's largest capital equipment show—exceeded even the most optimistic expectations with record visitors and orders.

In mid-April, West Germany's five major economic institutes acknowledged the strength of the upswing with a very upbeat joint forecast. They project 3.2-percent real GNP growth this year, up sharply from their 1984 projection of 2.1 percent they made last fall. In their view, the main impetus will come from strong foreign demand supported by firm domestic private consumption and investment. Despite the pickup in growth, the institutes expect a repeat of last year's 3-percent inflation.

Unemployment Still a Problem

Unemployment, the most pressing problem, remains near the postwar record even though it has inched downward since August from 9.4 to 9.1 percent. West German employers are reluctant to hire because of the extreme difficulty of dismissing an employee without a legal proceeding. Meanwhile, the labor force is growing by about 200,000 annually, due to an influx of young people at a time when retirements are at a postwar low. These demographic trends will continue through 1986, but thereafter the picture starts to change and by the end of the decade the labor force will begin to shrink.

The conflicting approaches by unions and the government to reduce the supply of labor have brought about a clash that threatens the worst labor disputes since 1978. The government is trying to encourage early retirement with legislation that became effective on 1 May. Under the new law, workers 58 to 62 years old may retire at 70 percent of their full pension, and the government will pick up one-third of the cost if the employer replaces the retiree with an unemployed worker. Several smaller unions already have settled on new wage contracts incorporating the early retirement provisions.

A number of key unions, however, are taking a different tack. The Metalworkers Union—West Germany's largest with 2.6 million members and the traditional pacesetter for organized labor—is waging a militant campaign for a 35-hour workweek with no cut in pay. Negotiations with management repeatedly have broken down over the issue. Government and business alike fear that a shortened workweek would increase costs and threaten both West German competitiveness and the economic upswing. Management has remained adamant despite strikes.

West Germany: Economic Outlook *Percent change* (except where noted)

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	1983	1984 Joint Institutes Forecast
Real GNP	**1.3**	**3.2**
Private consumption	1.0	1.6
Government consumption	−0.2	0.7
Investment	2.8	5.1
Equipment	5.8	5.6
Construction	0.8	4.8
Exports of goods and services	−1.0	8.4
Imports of goods and services	0.7	−0.7
Consumer prices	3.0	3.0
Current account surplus (*billion US $*)	4.0	7.8

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A Strong External Account

West Germany's current account balance grew slightly last year, reaching $4 billion. Although the trade surplus slumped due to sluggish demand in major developed-country markets—especially West Germany's primary trade partner, France—this was more than offset by steep reductions in the traditional deficit on services and transfers. The services balance improved by $2.4 billion, mainly from a rise in investment income and lower West German tourist expenditures. This year we expect strong improvement in the current account from the gathering recovery in West Germany's export markets and improved West German price competitiveness due to the strong dollar.

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Government Policy

The tight-fisted fiscal policies of Finance Minister Stoltenberg, aided by higher-than-expected tax revenues because of the recovery, brought the federal deficit down from $14 billion in 1982 to $12 billion last year—equal to 1.9 percent of GNP. With local governments following the federal lead, 1983's nominal 3-percent increase in general government expenditure was the lowest since 1945. Stoltenberg vows to continue budget consolidation, particularly in view of the likelihood of an increase in Bonn's contribution to the EC.

A protracted dispute has emerged within the government, however, over plans for a substantial cut in wage and income taxes after 1985. The coalition parties are squabbling over the timing of the cut, who the primary beneficiaries should be, and how much of the tax cut should be offset by increases in excise taxes and the VAT. The Free Democrats, who have not done well in recent state elections and fear they might not win the 5 percent of the vote necessary for parliamentary representation, want the money to be in the pockets of voters by the 1987 election with minimum offsets. Stoltenberg stands alone on the other extreme, insisting on a 45- to 50-percent offset and a 1988 implementation date; he probably will have to make substantial concessions. Chancellor Kohl is remaining aloof from the fray.

Outlook

The government sees its economic policies vindicated by the rosy forecasts especially after the five major economic institutes previously had raked the government's economic policy over the coals. Most forecasters project a continuation of the recovery into 1985, albeit at a somewhat slower pace. The success of the recovery already is leading some government and party leaders to propose increased spending for special causes, proposals Economics Minister Count Otto Lambsdorff labels shortsighted and greedy. Nevertheless, the temptation will be great to postpone politically contentious planks of the government's economic reform program, such as revamping social programs and eliminating subsidies and tax loopholes favoring special interests.

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Pakistan: The Economy and the Military

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Over the past few years, the Pakistani Government has been successful in making both guns and butter available in sufficient quantities to satisfy the armed forces and the civilian populace. Financing today's prosperity and military goals, however, has come at the expense of investment. This will make Pakistan heavily dependent on foreign capital for economic development and military modernization.

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The Military: Growing Economic Demands

The Pakistani Armed Forces traditionally have been the country's most prestigious institution and a unifying national force. Pakistani Army officers or former officers have ruled Pakistan since the first military coup in 1958 except for the years between 1971 and 1977 when Zulifikar Ali Bhutto was President and Prime Minister. The military role under the current martial law government extends all the way to the local level. President Zia plans to establish a civilian government by March 1985; but many observers believe he desires to be elected President.

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Zia's government is committing a larger share of its resources to defense. Its ongoing military modernization program could cost $6.5 billion by the end of the decade and requires expensive imports. Pakistan manufactures ammunition and small arms but does not produce heavy military equipment.

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Since the initiation of the military modernization program in 1981, government expenditures on the military have amounted to about 25 percent of the total government budget and 6 percent of GDP—modest increases over the late 1970s. Defense is allocated $1.9 billion in the current public budget.

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Military imports have become a larger share of total imports. The US Embassy in Islamabad estimates that military items could be 11 percent of the total import bill this fiscal year.

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Military spending has added to Pakistan's debt burden. Outstanding foreign debt is nearly $17 billion, including about $2 billion in foreign military debt. The military debt has grown rapidly since 1980 because of the modernization program. Debt service payments are about $900 million this year, equivalent to an estimated 12 percent of foreign earnings. This repayment burden currently is manageable.

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Sources of Supply and Financing

Pakistan regards US weapons and financing as the key to its modernization program. Since 1981, when the United States and Pakistan concluded a six-year $3.2 billion economic and military assistance package, Pakistan has purchased about $1.4 billion in military equipment from the United States:

- The Pakistani Air Force has purchased 40 F-16 fighter-bombers and the Navy 16 submarine-launched Harpoon antiship missiles.
- The Army has purchased 100 M-48 tanks, more than 100 major artillery pieces, and 10 helicopter gunships.

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The Role and Status of the Armed Forces

Most Pakistanis consider the military to be the protector of the state from external aggression rather than as an internal police force. Support for the Armed Forces is particularly strong among the Punjabis (60 percent of the population) and the Pathans (20 percent of the population) who have traditionally followed military careers. The military chose to remove the civilian presidents in 1958 and 1977 rather than engage in a systematic campaign of repression against widespread demonstrations in the Punjab. [redacted] 25X1

Support for the Armed Forces is not as strong among Sindhis (10 percent of the population) and the Baluchs (5 percent of the population). Neither of these ethnic groups are well represented in the Armed Forces. In the mid-1970s, the Army put down a major guerrilla movement in Baluchistan. In 1983, however, local police and paramilitary forces, rather than the Army, were used to restore order following unrest in Sind Province. The Army prefers to avoid the role of an internal police force. [redacted] 25X1

Morale in the Pakistani Armed Forces generally is good, [redacted] 25X1 *Pakistani officers and enlisted men live better than their civilian counterparts. Housing, food, and education for children are either heavily subsidized or free. Military hospitals are among the best in the country, and medical care is free. Many enlisted men learn technical trades that can be used after retirement from the Armed Forces, and officers learn managerial skills that are useful in the business world.* [redacted] 25X1

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[redacted] 25X1

We believe that the West European countries are the most likely alternative to the United States for modern arms and that Pakistan will attempt to meet some of its sophisticated weapons needs from them. Most of Pakistan's existing modern arms are from France, which will remain Islamabad's principal European supplier because of the broad range of quality weapons it produces. [redacted] 25X1

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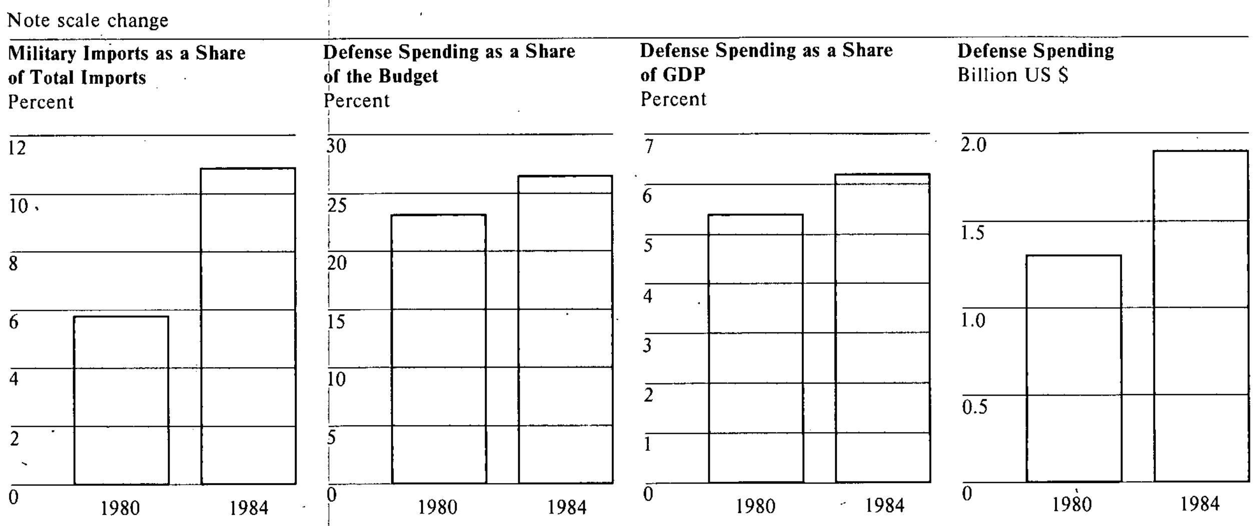
Over the past 25 years, China has supplied the Pakistani military with the bulk of its armaments. Although the level of Chinese assistance appears to have declined since the United States began selling Pakistan modern military equipment in 1981, we believe Islamabad will continue to buy substantial quantities of less sophisticated arms from China:

- China and Pakistan have similar foreign policy views on regional issues.
- China has been a reliable arms supplier in the past.
- The cost of Chinese equipment is considerably less than other sources.
- Pakistan has accumulated sizable inventories of Chinese equipment and will need to obtain spare parts. [redacted] 25X1

[redacted] 25X1

Pakistan: Burden of Defense, 1980 and 1984



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Pakistan: Balance of Payments [a]

Million US $

	1980	1981	1982	1983	1984 [b]
Current account	**−1,145**	**−991**	**−1,610**	**−554**	**−800 to −1,100**
Trade balance	−2,516	−2,765	−3,450	−2,989	−3,500
Exports (f.o.b.)	2,341	2,798	2,319	2,627	3,000
Imports (f.o.b.)	4,857	5,563	5,769	5,616	6,500
Military (f.o.b.)	280	419	571	603	700
Net services and transfers	1,371	1,774	1,840	2,435	2,400 to 2,700
Worker remittances	1,748	2,095	2,224	2,886	2,900 to 3,200

[a] Fiscal year ending 30 June.
[b] Projected.

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Domestic Support for Defense

The level of military spending is not a contentious issue in domestic politics. The military has received strong support even during the mid-to-late 1970s when there was a civilian government and a slight thaw in relations with New Delhi. India's recent large weapons purchases from the Soviet Union and the Soviet invasion of Afghanistan have propelled Pakistan's ambitious modernization program. Islamabad believes it is vulnerable to political and military pressure by New Delhi and Moscow and fears that Indian and Soviet strategic objectives ultimately threaten Pakistan's survival. The military believes that modern weapons are required to give Pakistan a credible military capability to deter aggression or sustain an effective defense until diplomatic efforts could stop an outbreak of fighting, and most Pakistanis share this view. [redacted] 25X1

Pakistan's impressive economic performance in recent years has helped to fend off potential criticism of military spending as well. The average Pakistani has benefited directly from economic prosperity. The economy recorded six consecutive years of rapid growth through FY 1983—almost 6 percent annually, according to US Embassy estimates. Remittances from overseas workers and higher domestic wages have improved the purchasing power of middle-class and poor families. Good weather and higher government procurement prices for grain have helped farmers. [redacted] 25X1

The improvement in Pakistan's foreign payments has contributed to the economic prosperity. Growth in worker remittances, expanded exports of manufactured goods, and lower imported oil costs brought Pakistan's current account deficit to the lowest level since the early 1970s. Capital inflows were boosted by IMF drawings under the final year of a three-year Extended Fund Facility arrangement and larger aid disbursements from the United States and other Western donors. By last summer, Pakistan had doubled its foreign exchange reserves to a record $2 billion, the equivalent of about four months of imports. [redacted] 25X1

Slower Economic Growth This Year

We believe the Pakistani economy is slowing this fiscal year:

- We believe GDP growth may be held to 4 percent—the lowest since Zia came to power—because of reduced agricultural output.
- The official consumer price index indicates prices are rising at an annual rate of at least 10 percent compared with less than 7 percent last year.
- Continuing government budget deficits and domestic bank borrowing is siphoning capital from the private sector as well as contributing to inflationary pressures.
- Worker remittances are growing at a much slower pace than in recent years.
- The trade balance is likely to show a significant deterioration from last year because of a shortfall in earnings from cotton exports and a sharp jump in prices for imported edible oils.
- Capital inflows will be reduced because of the premature termination of the Extended Fund Facility with the IMF, some difficulties lining up World Bank loans, and a slowdown in receipts of project aid and refugee assistance from foreign donors. [redacted] 25X1

Outlook

Despite this year's economic slowdown, we do not believe that military spending will become a contentious political issue for Zia this year. President Zia has acted quickly to assure the population that the economic situation is under control. We believe he will continue to intervene in the marketplace to keep a lid on prices by releasing commodities from government stocks and importing basic items in

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short supply to shield both the military and the general population from the economic slowdown. Foreign exchange reserves are large enough to boost imports of consumer goods in the near term. [redacted]

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Increased spending for consumption and defense could take a toll on development. High levels of capital investment are necessary if Pakistan is to provide jobs for its rapidly growing population. We believe that the causes of Pakistan's explosive population growth—high birth rates and a rapid decline in death rates—will last at least through the end of the century. Estimates of annual population growth rates range as high as 3 percent over the next 20 years. Thus the population could reach or exceed 150 million in the year 2000 compared with 95 million in mid-1983. A decline or even a leveling off of job opportunities in the Middle East will eliminate an important safety valve in the labor market. [redacted] the domestic labor market can absorb effectively only about half of all eligible male workers; the remainder are unemployed, underemployed, or work abroad. [redacted]

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Satisfying military and consumer needs will continue to require a high level of remittances and foreign financial assistance. Barring higher levels of outside financing, Pakistan may have to reduce nonmilitary imports. Such a move, however, would be politically risky. [redacted]

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South Korea: Grappling With Import Liberalization

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South Korea's recently announced import liberalization program is part of a broad effort by many of the country's leading economic officials to open the economy by reducing government intervention and relying more on market forces. Several interest groups oppose the program, and its ambitious target—the lowering of South Korea's level of protection to developed-country standards by 1988—could be undermined by the same special exceptions and tariff barriers that have muted the impact of earlier liberalization efforts. Nonetheless, we expect the growing belief within the government that reduced protection can strengthen South Korean industrial competitiveness will result in a selective relaxation of import barriers by the late 1980s. 25X1

The Liberalization Program

The import liberalization program announced in December 1983 and in February 1984 has as its goal a phased reduction in both tariff and nontariff protection over the next five years. Initially, many commodities will be freed from nontariff protection but will be subjected to higher tariffs. By the late 1980s these tariffs are scheduled to be reduced. 25X1

More than 1,500 items now require prior approval from private trade organizations or a government ministry before they can be imported; in practice, approvals are rarely granted. Machine tool imports, for example, must be approved by the Korea Machine Tool Industry Association. Under the new program, about three-fourths of these items will no longer require approval. 25X1

Even commodities on the government's automatic approval list are not all freely imported. Many are subject to a surveillance system, under which additional imports are banned once certain levels are reached. Although 80 percent of all trade items are currently on the automatic approval list and Seoul plans to increase this to 95 percent by 1988, we estimate that other barriers—including special tariffs—reduce the real number of items freely imported to about 60 to 65 percent of trade items. Mirroring government priorities, barriers are weighted toward protecting small- and medium-sized firms, infant industries (such as electronics, machine tools, and transport equipment), and farm interests. Tight restrictions on imports of consumer goods result from domestic priorities and foreign payments concerns. South Korea has traditionally run large current account deficits. 25X1

Seoul plans to reduce tariff rates to average developed-country levels by 1988, from the current average of 23 percent of value to 17 percent. The government will retain an emergency tariff system allowing it to raise tariffs up to 40 percentage points above general rates for six months on selected commodities. In addition, an adjustment tariff system was introduced with the liberalization program, allowing Seoul to impose tariffs of up to 100 percent on products freed from nontariff protection. 25X1

The Progress of Liberalization Efforts

Seoul maintained a broadly restrictive import control system until the late 1970s when it removed restrictions from many raw materials and capital goods not produced domestically. The primary goal of the change was to slow rapid inflation by increasing the supply of foreign goods. Strengthening industrial competitiveness and meeting the complaints of trading partners were secondary objectives. 25X1

Although Seoul at that time raised the number of items on the automatic approval list from about 50 percent of commodity categories to 68 percent, most items freed from protection did not compete with domestic producers. We believe that the 77-percent surge in import volume that occurred in the 1977-79 period primarily reflected a domestic investment boom and not the trade liberalization. The liberalization program, nonetheless, probably contributed to some of the increase in foreign purchases, perhaps adding several hundred million dollars to the import bill. Following the second oil shock in 1979, Seoul froze further liberalization. 25X1

Since 1981, top economic officials have made import liberalization a top priority. Kim Jae-ik, the former Blue House Senior Secretary for Economic Affairs, was in the forefront of this effort until his death in the Rangoon bombing last October. Finance Minister Kim Mahn Je, Deputy Prime Minister Shin Byong Hyun, Presidential Secretary General Kang Kyong Shik, Senior Secretary for Economic Affairs Sakong Il, and Overseas Cooperation Council Director Kim Ki Hwan are now the prime movers. Most of these officials were educated in the United States, and they are convinced that opening the import market will strengthen the economy. They link trade liberalization to efforts to reduce government intervention and rely more on market forces. They also seek to reform the financial sector and to ease foreign investment regulations. 25X1

These officials argue that reductions in import protection will:

- Force South Korean industry to increase efficiency, upgrade quality, and boost technology levels and thus become more competitive in world markets.
- Help defuse protectionist sentiments in developed countries. Several countries, including the United States, have linked South Korean access to their markets to a reduction in Seoul's import barriers. 25X1

Ranged against these liberalizers are the Commerce and Industry Ministry, Agriculture and Fisheries Ministry, businessmen, and farm groups. They are concerned that many domestic producers cannot compete with foreign goods and will go bankrupt. These groups have used their political clout to ensure that import barriers are removed gradually. They have succeeded in limiting the number of commodities freed from restrictions and have argued successfully to have higher tariffs imposed on many products freed from nontariff protection. 25X1

A favorite tactic of these groups is to keep protection on the market segment where demand is greatest while agreeing to lift barriers from the subcategories where demand is small or nonexistent. For example, Seoul moved carpets and rugs—certain wool and acrylic types—to the automatic approval list in 1983 but left barriers in force on subcategories where almost all the demand existed—that is, nylon carpets. The same tactic was used in "liberalizing" imports of loudspeakers—only speakers under 5 inches in diameter were moved to the automatic approval list. This tactic also is being used to restrict imports of computer equipment, cameras, and fabrics. 25X1

The protectionists have used special laws related to health or safety standards to ease the impact of liberalization as well. Refrigerators, for example, were "liberalized" but are subject to an "electric supplies safety control law" enforced by a division within the Ministry of Commerce and Industry. Through this tactic, Seoul bans refrigerators as not being up to Korean standards. For glassware, limits on the size or value of shipments are so low that exporters cannot afford to compete in the market—a trader can only get a license for up to $10,000 every 15 days. 25X1

Impact on Imports

Such tactics in the past have caused trade liberalization programs to be long on rhetoric and short on substance. Although Seoul has shifted hundreds of items to the automatic approval list since 1981, it has chosen products in which South Korea has a

South Korea: Imports of Selected Liberalized Items, 1982-83[a]

Thousand US $

Commodity	Before Liberalization	After Liberalization
Polyester fibers	7	135
Acrylic fibers	67	36
Polypropylene fibers	0	0
Viscose rayon fibers	2	2
Pile and chenille fabrics of polyester fiber	19	15
Pile and chenille fabrics of acrylic fiber	67	63
Pile and chenille fabrics of other manmade fibers	8	12
Pile and chenille fabrics of silk	0	0
Pile and chenille fabrics of other fibers	0	3
Knitted fabrics of acrylic fibers	72	37
Knitted fabrics of acetate filament yarn	13	23
Knitted fabrics of regenerated fibers	0	3
Diamonds, industrial use	0	0
Semiprecious stones for machinery	128	178
Electric motors	141	83
Transformers	56	94
Voltage regulators	89	105
Rectifiers	62	166
Sound equipment	156	193
Locker shovel	399	2,577
Semiconductor parts	9,346	11,210
Electronic switching systems	11,455	16,503
Parts of rotary connectors	6	81
Parts of dairy equipment	15	12
Parts of heat exchangers	453	89
Parts of boilers	4	6

[a] Average based on imports for six- or 12-month periods before and after liberalization.

strong competitive advantage. In last year's trade plan, for example, textile products accounted for about 35 percent of all items freed from nontariff protection. Since 1981, Seoul has placed almost 200 commodities on the surveillance list, giving the government the option of banning the import of these goods if their share of the market grows too rapidly. In addition, about 100 items freed from nontariff protection last year were subjected to higher tariffs. The tariff on cosmetic soaps, for example, was hiked from 30 to 70 percent. An additional constraint is that some commodities—cosmetics are an example—can be imported only by domestic producers of the product. 25X1

As a result of such measures, imports of most items freed from nontariff protection have remained negligible—generally less than $1 million annually per commodity, according to our analysis. We have identified only a few cases in which purchases of foreign goods have risen substantially following liberalization. These are primarily subcomponents and equipment needed to produce export goods and products that embody special technology—for example, ship parts, electronic switching system equipment, and selected semiconductor parts. 25X1

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Outlook

Despite Seoul's unimpressive record on liberalization, we believe its new long-term plan will result in some easing of protection by 1988. The key argument of the liberalizers—namely that greater reliance on market forces will benefit the Korean economy—is gaining wider acceptance. The post-Rangoon cabinet is heavily weighted with proponents of liberalization, and we believe their influence is on the rise. They have, for example, recently pushed through policies that are prerequisites for opening the banking and foreign investment sectors to greater competition. In addition, pressure from the United States at recent economic meetings, in our view, has convinced the Chun government that it must deliver "true" import liberalization to avoid trade disputes with Washington. 25X1

We anticipate that Seoul will continue to focus on removing barriers from commodities that South Korea can manufacture most competitively—such as textiles—and from those needed for generating exports goods—such as machinery. We believe consumer goods, which are currently tightly restricted, will also be imported more freely by 1988. 25X1

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Seoul will remain reluctant to remove protection from its emerging industries—electronics, machine tools, and autos. In our judgment, farm products are the least likely to be freed from protection. The rural sector is an important source of support for the government, and farm interests are strongly represented in the National Assembly. Seoul is also concerned about maintaining urban-rural income equality. [redacted] 25X1

In our view, the forward movement will be steady but cautious. Seoul will continue to use the surveillance system and special tariffs to control the pace of liberalization. We believe several factors will determine the speed of liberalization:

- South Korea's foreign payments position and access to foreign capital are probably the most important variables. An improved current account would make it easier for Seoul to remove import barriers. Payments problems, on the other hand, would take precedence over import liberalization; Seoul must service a $40 billion foreign debt.

- The speed with which South Korea's emerging industries reach international competitiveness will dictate how fast barriers are removed from many industrial commodities. Even the proponents of liberalization believe that these industries need some breathing space.

- The level of protectionism in developed countries also will play a role. Seoul will be looking for a lessening in overseas barriers to justify to its public the removal of its own controls. [redacted] 25X1

[redacted] 25X1

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Japan's New Regional High-Technology Centers

MITI has launched a program to develop up to 19 high-technology centers by 1990. We believe the "technopolis" program will become the largest regional industrial development effort sponsored by the government in two decades.

25X1

The Program

MITI's technopolis program has three goals:

- To boost R&D activities and manufacturing in high-technology industries.
- To alleviate crowding in the large cities.
- To spur economic growth outside major urban areas.

Inspired by the commercial success of North Carolina's Research Triangle and California's Silicon Valley, the program is balanced to support small-venture firms as well as large established companies. The Japanese believe that smaller firms will spur creativity and innovation and that large, existing firms will benefit from this dynamic environment.

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MITI originally planned to develop no more than six model technopolises, but regional political pressures forced the designation of several additional sites. In March, MITI announced the first nine locations for new high-technology centers; five additional sites are scheduled to be designated later this year. Major areas of technology to be pursued at the centers include biotechnology, electronics, mechatronics (a combination of machine tools and electronics), new materials, and computer software. R&D in mechatronics will be performed at all but two of the first 14 technopolis sites, while 11 of the 14 centers will do work in biotechnology and electronics.

25X1

The Japanese are actively courting foreign firms for the technopolis program. The Tokyo-based

Japan: Proposed High-Technology Cities

Technopolis	Prefecture/Host City
Cities named in March	
Nagaoka	Niigata/Nagaoka
Toyama	Toyama/Toyama-Takaoka
Hamamatsu	Shizuoka/Hamamatsu
Hiroshima-Chuo	Hiroshima/Kure
Ube	Yamaguchi/Ube
Kumamoto	Kumamoto/Kumamoto
Kenhoku-Kunisaki	Oita/Oita-Beppu
Miyazaki	Miyazaki/Miyazaki
Kokubu-Hayato	Kagoshima/Kagoshima
Cities to be named later this year	
Hakodate	Hokkaido/Hakodate
Akita	Akita/Akita
Utsunomiya	Tochigi/Utsunomiya
Kibikogen	Okayama/Okayama
Kurume	Fukuoka-Saga/Kurume

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American and West German Chambers of Commerce have toured the sites, and last spring representatives from several prefectures and the Japan External Trade Organization held investment seminars in New York, Chicago, Los Angeles, and San Jose. Three US companies have already built factories in Kyushu's Oita Prefecture.

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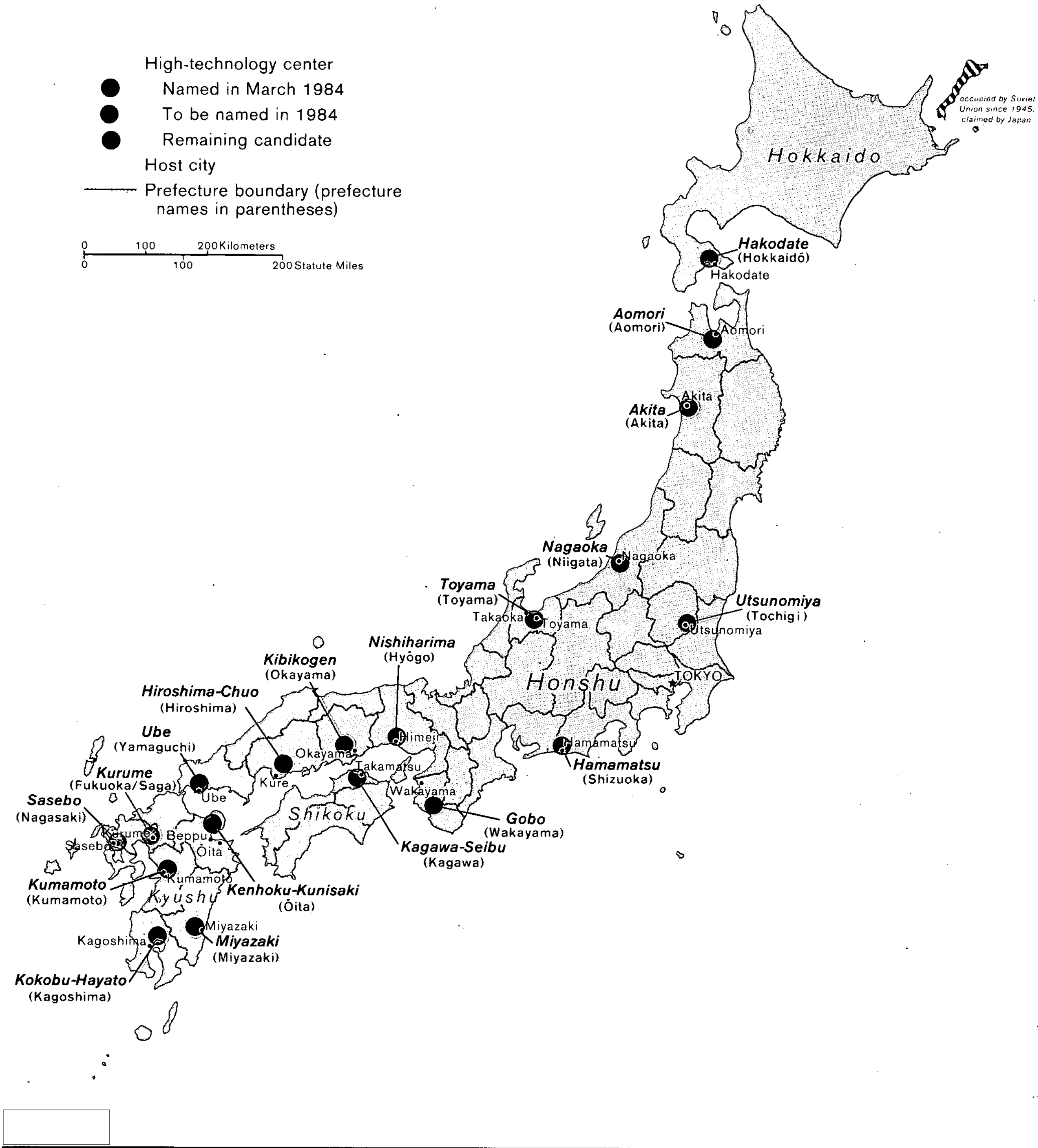
Government Financial Incentives

Tokyo and the local governments have designed a package of incentives to assist high-technology

Japan's Proposed High-Technology Centers and Host Cities



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firms in building facilities in a new technopolis. Subsidies, low-interest loans, and tax breaks from central and local governments are supplemented by loans from private banks, which in some cases will be guaranteed by government agencies. Major incentives in FY 1984 include:

- $11.3 million from Tokyo to aid assimilation of high technology by small business and the relocation of industrial facilities.

- Loans at 7.5 percent or less from the Japan Development Bank and the Hokkaido Tohoku Development Corporation. We expect over $100 million of the existing regional development loan program to be allocated for the technopolis project. The Japan Development Bank also will finance leases of machinery and equipment for use in a technopolis.

- Development loans at 2.7 percent from the Small and Medium Enterprise Agency for up to $50 million.

- Central and prefectural government loan insurance funds to guarantee R&D development loans issued through commercial banks. 25X1

Private Financing

The prefectural governments of Nagaoka, Hamamatsu, and Kumamoto have established a "Technopolis Trust System" in cooperation with Sumitomo Trust Bank. Under this system, property owners entrust land to a bank that funds construction of factories and equipment. In return, the banks receive 5 to 10 percent of future land rents. The system is intended to permit landholders to retain ownership of their property while allowing development to proceed. 25X1

Sumitomo Trust has estimated that the plants in a typical technopolis will cost more than $400 million. It is prepared to provide financing for development in each of the technopolises in conjunction with city banks and government financial corporations. Other major trust banks, including Mitsubishi Trust and Mitsui Trust, have decided to establish similar trust systems. 25X1

Outlook

Despite the MITI push, budgetary constraints and the traditional preference of Japanese firms to locate high technology in major urban areas could limit the pace of the technopolis program. For major R&D facilities, companies may want to remain close to existing concentrations of expertise in the big cities. Moreover, Japan's continuing need to restrain budget deficits may make it difficult to provide significant amounts of public funds for the technopolis program. 25X1

Nonetheless, we believe the technopolis program will attract foreign firms and can strengthen Japanese efforts in high-technology production and R&D. Colocation of high-technology firms will facilitate intercompany information flows, and attracting foreign firms could provide increased access to foreign technology. We believe foreign firms are likely to be drawn to the technopolis concept as a means to gain entry into the Japanese market. Moreover, since most technopolis areas are represented by powerful politicians in the Diet, the interests of foreign firms locating in these regions should be well served in the legislative process. 25X1

The technopolis concept will be helped by the current trend of some firms to move high-technology industries and R&D facilities away from big cities. Japan's nine major semiconductor manufactures, for example, have already located 23 of their 26 large-scale integrated circuit plants outside metropolitan areas. The program will also spur development of small- to medium-size high-technology companies in the outlying regions. Major corporations have started to build new research facilities

Technopolis Requirements

According to MITI's Technopolis Plan, the qualifying requirements for selection are:

- *The host city must have a population of at least 150,000.*
- *The host city must provide land within a 30-minute commute from the central city.*
- *The host city must have universities with scientific and technological disciplines.*
- *The host city must already have some high-technology enterprises that have close working relationships with the area's universities and government R&D institutions.*
- *The host city must have either a highway interchange, an airport, or a bullet train station within a 30-minute commute from the technopolis.* 25X1

for semiconductors, computer software, new materials, and biotechnology outside metropolitan areas. MITI hopes to reinforce regional R&D capabilities by expanding and making more extensive use of the network of more than 700 existing government R&D facilities located throughout the country.

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